Supreme Court, U.S.
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No. 09-

IN THE

Supreme Court of the United States

JEFFREY W. BADER,

Petitioner,

v.

LLOYD BLANKFEIN, ET AL.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

ALEXANDER ARNOLD GERSHON
Counsel of Record
GLORIA KUI MELWANI
BARRACK, RODOS & BACINE
1350 Broadway, Suite 1001
New York, New York 10018
(212) 688-0782
agershon@barrack.com

Counsel for Petitioner

228756

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

QUESTION PRESENTED FOR REVIEW

In a stockholder's derivative action under § 14(a) of the Securities Exchange Act, where the exceptions to the pre-suit demand rule are governed by the law of the state of incorporation, did the Second Circuit blatantly nullify state law by holding that the business judgment rule protects the disclosure of false information in a proxy statement?

PARTIES TO THE PROCEEDING

Pursuant to Rule 14.1(b), the following list identifies all of the parties appearing here and before the United States Court of Appeals for the Second Circuit.

The Petitioner here and appellant below is Jeffrey W. Bader.

The Respondents here and appellees below are Lloyd C. Blankfein, Gary Cohn, Jon Winkelried, John Browne, John H. Bryan, Claes Dahlbäck, Stephen Friedman, William W. George, Rajat K. Gupta, James A. Johnson, Lois D. Juliber, Edward M. Liddy, Ruth J. Simmons, John S. Weinberg, Christopher A. Cole, J. Michael Evans, Edward C. Forst, Richard A. Friedman, Richard J. Gnodde, Kevin W. Kennedy, Peter S. Kraus, Masanori Mochida, Thomas K. Montag, John F.W. Rogers, Eric S. Schwartz, Michael S. Sherwood, David M. Solomon, David A. Viniar, Gregory K. Palm, Esta E. Stecher, Alan M. Cohen, and The Goldman Sachs Group, Inc.

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Jeffrey W. Bader petitions the Supreme Court of the United States for a writ of certiorari to review the decision of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit is not reported, but is available at, 2009 WL 4822818 and 2009 U.S. LEXIS 27082, and is reprinted at Pet. App. 1a. The opinion of the United States District Court for the Eastern District of New York dismissing the complaint is also not reported, but is available at 2008 WL 5274442 and 2008 U.S. Dist. LEXIS 102698, and is reprinted at Pet. App. 7a.

STATEMENT OF JURISDICTION

The Court of Appeals for the Second Circuit entered a Summary Order on December 14, 2009 and affirmed the District Court's dismissal of the complaint. The jurisdiction of this court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES, RULES, AND REGULATIONS INVOLVED

The claims herein arise under § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) and provides, in pertinent part:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of

> any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12.

The claims herein also arise under United States Securities and Exchange Commission ("SEC") Rule 14a-9, 17 C.F.R.§ 240.14a-9; Schedule 14A, 17 C.F.R. § 240.14a-101, and Item 402 of Reg. S-K, 17 C.F.R. § 229.402, and under the laws of the several states including, particularly, the State of Delaware. These provisions are lengthy and are reprinted in the Pet. App. 31a.

STATEMENT OF THE CASE

The court of first instance, the United States District Court for the Eastern District of New York, had jurisdiction of this matter pursuant to 15 U.S.C. § 78aa and 28 U.S.C. § 1367.

This case concerns a defective proxy statement for the March 27, 2007 annual meeting (the "2007 Proxy Statement") of stockholders of defendant The Goldman Sachs Group, Inc., a Delaware corporation ("Goldman Sachs" or the "Company"). For that annual meeting, their directors, who are defendants at bar, solicited the

stockholders' approval for, *inter alia*, their re-election to the board of directors. SEC regulations then in effect required that, when such an election was on the agenda, the proxy statement must contain representations about the compensation paid to directors and executive officers of the Company for the fiscal year (Pet. App. 31a), including either the hypothetical future value or grant date present value of stock options granted to the "named executive officers."[1] (Pet. App. 33a.) The regulations further provided that, if the proxy statement disclosed the present value on the grant date, that value must be calculated under "any option pricing model." (Pet. App. 33a.) The new SEC regulations no longer allow the representation of the hypothetical future value and instead require disclosure of the grant date fair value in accordance with an option pricing model that takes into account the time value of money and the substantive characteristics of the option such as the volatility of the underlying stock, the dividends if any, and the time of expiration of the option.

The 2007 Proxy Statement represented that the calculation of the grant date present value of options granted to the named executive officers was calculated using the Black-Scholes option pricing model. But the represented value was materially false, in contravention of Rule 14a-9 (Pet. App. at 34a): the actual value was materially higher than represented.

The defendants have conceded that they derived the grant date value by taking a discount. ("Goldman Sachs

[1] The "named executive officers" included defendants Lloyd C. Blankfein, Gary D. Gohn, Jon Winkelried, David A. Viniar and John S. Weinberg.

. . . applied certain discounts to the options valuations." Defs.' App. Br. at 39-40). But the 2007 Proxy Statement omitted to disclose that discount. This omission contravened Instruction 9 of Item 402(c) of Regulation S-K, 17 C.F.R. § 229.402(c), which provides that this discount be disclosed in a footnote to the Options Granted Table in the proxy statement. (Pet. App. at 34a.) By contrast, the 2006 Proxy Statement reported that a discount was taken. Accordingly, a reasonable Goldman Sachs stockholder would have understood that no discount was taken in the 2007 Proxy Statement.

Because this is a stockholder's derivative action on behalf of a Delaware corporation, the complaint alleges that pre-suit demand is excused because the misrepresentation of the stock option values is not protected by Delaware's business judgment rule. The District Court concluded that a false statement by directors was not protected by the business judgment rule (Pet. App. 20a), but went on to hold that directors nevertheless could exercise business judgment to decide whether to bring the case and, therefore, demand was required. (Pet. App. 20a-21a.) The Second Circuit inverted the reasoning of the District Court and held that if the disclosure was not protected by the business judgment rule, demand would be excused. (Pet. App. 5a.) But the Second Circuit held that because the disclosure at bar required "thought," the disclosure was protected by the business judgment rule. This is exactly the opposite of Delaware law. (Pet. App. 5a.)

REASONS FOR GRANTING THE PETITION

The Court of Appeals Blatantly Nullified Delaware Law.

The Second Circuit's reading of Delaware law amounts to a "blatant federal-court nullification of state law." *Leavitt v. Jane L.*, 518 U.S. 137, 145 (1996), because its determination of Delaware law in this case is "plainly wrong." *Id.* at 145. Every Delaware court that has considered the point has held that disclosure is not protected by the business judgment rule. All courts have the duty to construe Delaware corporate law correctly because of the predominance of Delaware corporations and because other states look to Delaware law in formulating their own rules of corporation law. *See, e.g.*, *Nevada Classified School Employees Ass'n v. Quaglia*, 177 P.3d 509, 511 (Nev. 2008); *In re PSE&G Shareholder Litig.*, 801 A.2d 295, 307 (N.J. 2002).

The Court of Appeals nullified Delaware case law regarding whether the business judgment rule protects decisions concerning corporate disclosure. The leading case is *In re Anderson, Clayton Shareholders' Litigation*, 519 A.2d 669 (Del. Ch. 1986). Although not a case from the highest court in Delaware, it is widely followed, as shown below.

In *In re Anderson, Clayton Shareholders' Litigation*, the Chancery Court held that the "weighty presumption" of the business judgment rule does not protect boards when they make disclosures to stockholders. *Id.* at 675. The court held that such a disclosure decision "is not a decision concerning the

management of business." *Id.* at 675. The *Anderson Clayton* court also held that the quality of disclosure is something that courts can adjudicate, but the wisdom of a business decision ordinarily is not:

> The quality of disclosure is inherently something that the court itself must ultimately evaluate. It would be surprising, for example, to find a case in which a plaintiff has demonstrated to a court's satisfaction that a truly important piece of information, within the knowledge of the board, had not been disclosed, but the court nevertheless denied an application for a preliminary injunction on the basis that while the Court found the information highly material, reasonable men could differ on the subject and the board's decision not to disclose, having been made in good faith, should be deferred to. I doubt that that is the law.

Id. at 675. There is no reason for a court to defer to a board's decision to omit a disclosure on the theory that reasonable people could differ about whether to disclose it. *Id.* at 675.

Therefore, the Circuit Court's holding that disclosure "affords the directors an opportunity to exercise their reasonable business judgment" is in direct conflict with Delaware law. (Pet. App. 5a (internal citations omitted.)) Disclosure is not is not a matter of business judgment because the decision regarding disclosure is not part of business management. *See, e.g., In re Anderson, Clayton Shareholders' Litigation*, 519

A.2d at 675 (". . . [T]he question whether shareholders' have, under the circumstances, been provided with appropriate information upon which an informed choice on a matter of fundamental corporate importance may be made, is not a decision concerning the management of business and affairs of the enterprise."); *Lewis v. Leaseway Transp. Corp.*, 1990 WL 67383, at *6 (Del. Ch. May 16, 1990) (". . . [T]he business judgment rule has no applicability to the question whether shareholders have been provided with appropriate information to make an informed choice because the underlying duty (candor) does not concern the management of business and the affairs of the corporation."); *In re Mobile Communications Corp.*, 1989 WL 997182, at *5 (Del. Ch. Apr. 3, 1989) ("independence (or good faith or due care) of a board is not directly relevant to a determination whether a disclosure obligation has been satisfied (disclosure not being a question of business judgment."). The Circuit Court's statement that the board's actions:

> could not have been done automatically or without thought. Rather, determining which figure to disclose and which pricing model to apply required discretion and an exercise of business judgment.

is unsupported by any Delaware case. (Pet. App. at 5a.)

Other courts have more accurately interpreted the Delaware demand policy. In *In re Tri-Star Pictures, Inc. Litigation*, 1990 WL 82734 at *8 (Del. Ch. Jun. 14, 1990),

then Vice Chancellor Jacobs[2] held that applying the demand requirement to a stockholder's derivative action based on a false proxy statement would be inconsistent with Delaware case law that the business judgment rule does not apply to false disclosures and omissions in a proxy statement.[3] Judge Duffy in *Katz v. Pels*, 774 F.Supp. 121, 127 n.5 (S.D.N.Y. 1991), cited *Tri-Star* to hold that ". . . false Proxy claims are not subject to the demand requirement of Delaware Chancery Court Rule 23.1."

It is important to have a consistent application of Delaware law in the federal courts. This court held in *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 106 (1991), that *Burks v. Lasker*, 441 U.S. 471 (1979), "counsels against establishing *competing* federal- and state-law principles on the allocation of managerial prerogatives within the corporation." *Kamen*, 500 U.S. at 106 (emphasis added). *Burks* also held that "[i]t is true that in certain areas we have held that federal statutes authorize the federal courts to fashion a complete body of federal law. Corporation law, however, is not such an area." *Burks*, 441 U.S. at 477 (internal citations omitted). Even if the claim is based on federal law, the law governing the demand requirement must

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[2] Now Associate Justice Jacobs of the Delaware Supreme Court.

[3] "[T]he entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability." *Siegman v. Tri-Star Pictures, Inc.*, 1989 WL 48746, at *10 (Del. Ch. May 5, 1989) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

be the law of the state of incorporation. *See Kamen v. Kemper Financial Services, Inc.*, 500 U.S. at 106.

The correct interpretation of Delaware corporation law is especially important because various courts look to the Delaware courts for guidance on the subject. *See, e.g., RSL Communications PLC v. Bildirici*, 649 F. Supp. 2d 184, 206 (S.D.N.Y. 2009); *In re Ivan F. Boesky Securities Litig.*, 129 F.R.D. 89, 97 (S.D.N.Y. 1990) ("Delaware has long been recognized as the fountainhead of American corporations and that its Courts of Chancery are known for their expert exposition of corporate law."). This court should not allow the Second Circuit to depart so far from the widely accepted body of Delaware corporate law.

CONCLUSION

For the reasons expressed above, this court should grant the petition for writ of certiorari.

Respectfully submitted,

ALEXANDER ARNOLD GERSHON
Counsel of Record
GLORIA KUI MELWANI
BARRACK, RODOS & BACINE
1350 Broadway, Suite 1001
New York, New York 10018
(212) 688-0782
agershon@barrack.com

Counsel for Petitioner

March 15, 2010

APPENDIX

APPENDIX A — SUMMARY ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED DECEMBER 14, 2009

UNITED STATES COURT OF APPEALS SECOND CIRCUIT

No. 09-0309-cv

JEFFREY W. BADER,

Plaintiff-Appellant,

v.

LLOYD C. BLANKFEIN, GARY COHN, JON WINKELRIED, JOHN BROWNE, JOHN H. BRYAN, CLAES DAHLBACK, STEPHEN FRIEDMAN, WILLIAM W. GEORGE, RAJAT K. GUPTA, JAMES A. JOHNSON, LOIS D. JULIBER, EDWARD M. LIDDY, RUTH J. SIMMONS, JOHN S. WEINBERG, CHRISTOPHER A. COLE, J. MICHAEL EVANS, EDWARD C. FORST, RICHARD A. FRIEDMAN, RICHARD J. GNODDE, KEVIN W. KENNEDY, PETER S. KRAUS, MASANORI MOCHIDA, THOMAS K. MONTAG, JOHN F.W. ROGERS, ERIC S. SCHWARTZ, MICHAEL S. SHERWOOD, DAVID M. SOLOMON, DAVID A. VINIAR, GREGORY K. PALM, ESTA E. STECHER, ALAN M. COHEN,

Defendants-Appellees,

THE GOLDMAN SACHS GROUP, INC.,

Nominal-Defendant-Appellee.

Dec. 14, 2009

Appendix A

Present JOSÉ A. CABRANES, DEBRA ANN LIVINGSTON, Circuit Judges, and EDWARD R. KORMAN, District Judge.*

SUMMARY ORDER

UPON DUE CONSIDERATION, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the judgment of the District Court be **AFFIRMED.**

Plaintiff-appellant Jeffrey W. Bader appeals from an order dismissing his stockholder's derivative action, on behalf of nominal-defendant the Goldman Sachs Group, Inc. ("Goldman Sachs"), a Delaware corporation, against defendants-appellees, the directors of Goldman Sachs, based on a proxy statement that allegedly omitted disclosures that the SEC required and contained materially false statements and omissions. Plaintiff's action arises under section 14(a) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78n(a), and the regulations of the United States Securities and Exchange Commission ("SEC"). The District Court dismissed plaintiff's derivative action for failure to make pre-suit demand on the board of directors. Plaintiff timely appealed. We assume the parties' familiarity with the underlying facts, the procedural history, and the issues on appeal.

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* The Honorable Edward R. Korman, of the United States District Court for the Eastern District of New York, sitting by designation.

Appendix A

As a threshold matter, defendants argue that this appeal is moot. Plaintiff responds that this claim falls under an exception to the mootness doctrine because it seeks relief for a wrong that is "capable of repetition, yet evading review." *Heldman on Behalf of T.H. v. Sobol*, 962 F.2d 148, 157 n. 9 (2d Cir.1992); *see also Honig v. Doe*, 484 U.S. 305, 322-23, 108 S.Ct. 592, 98 L.Ed.2d 686 (1988) (recognizing an exception to the mootness doctrine upon finding a "sufficient likelihood that [plaintiff] will again be wronged in a similar way, and that any resulting claim [plaintiff] may have for relief will surely evade . . . review" (internal quotation marks and citation omitted)); *Seibert v. Sperry Rand Corp.*, 586 F.2d 949, 951 (2d Cir.1978) (recognizing an exception to the mootness doctrine for a wrong capable of recurrence yet evading review). While we recognize that the particular SEC regulation at issue in plaintiff's claims is no longer in effect, the underlying alleged wrongful conduct—providing misleading calculations in proxy statements under section 14—is a wrong that is "capable of repetition, yet evading review." *Heldman*, 962 F.2d at 157 n. 9. Plaintiff's appeal is, therefore, not moot.

On appeal plaintiff argues that (1) there is no pre-suit demand requirement for shareholder derivative suits under section 14 of the 1934 Act because proxy misstatements are not a product of business judgment, and (2) accordingly, demand was excused in the instant case because this proxy misstatement was not a product of the valid exercise of business judgment, and (3) in the alternative, demand was excused in this particular

action as futile because the directors were either interested or not independent. Defendants respond that section 14 suits are not generally exempt from a demand requirement, and that plaintiff was not excused on either ground for failing to meet that requirement before bringing his derivative suit so the District Court properly dismissed plaintiff's suit. For the reasons stated below, we affirm the District Court's dismissal of plaintiff's suit.

Plaintiff bases both grounds for excusing demand on *Aronson v. Lewis*, a Delaware case which provides that demand should be excused when a reasonable doubt is created that (1) the directors are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. 473 A.2d 805, 812 (Del.1984), *overruled on other grounds by Brehn v. Eisner*, 746 A.2d 244 (Del. 2000).

No clear rule has emerged from the district courts that have addressed this issue, and we do not find the need to set forth a bright-line rule at present, as demand under *Aronson* is an inquiry *specific to the challenged transaction.* We therefore decline plaintiff's invitation to create a blanket rule under the second prong of *Aronson* declaring that demand is generally not required in a shareholder derivative suit alleging violations of section 14 of the 1934 Act.

Plaintiff further contends that because the SEC regulation at issue here required "full disclosure,"

the proxy statement disclosure was not a matter of business judgment so that demand should be excused. We disagree. The particular disclosure at issue on this appeal was a business judgment. The directors had a legal obligation to disclose *either* the potential realizable value of stock options granted to officers *or* the present value of the stock options granted. The regulations further provided that if the proxy statement disclosed the present value, it could be calculated under "*any* option pricing model." 17 C.F.R § 229.402(c)(2)(vi) (Apr. 1, 2006) (emphasis added). The information required to be disclosed could not have been done automatically or without thought. Rather, determining which figure to disclose and which pricing model to apply required discretion and an exercise of business judgment.

Where, as here, directors must use valid business judgment to meet their obligations under section 14, the demand requirement for a derivative shareholder suit cannot be excused. The demand requirement "affords the directors an opportunity to exercise their reasonable business judgment" by upholding the fundamental concept that directors manage the business and affairs of a corporation. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 533, 104 S.Ct. 831, 78 L.Ed.2d 645 (1984). Although we can anticipate a situation in which demand would be futile, and thus excused under the second prong of *Aronson*, in a section 14 derivative suit, that is not the case here. We agree with the District Court that demand was necessary here and was therefore not excused.

Plaintiff also argues that he was excused from the demand requirement under the first prong of *Aronson* because a majority of the directors were either interested or not independent. As Judge Townes stated in her thoughtful and comprehensive opinion, plaintiff's "complaint[,] [even if amended, would] not create a reasonable doubt that the majority of the directors are disinterested and independent, and therefore fails to establish that it would have been futile to make demand upon Goldman's Board of Directors prior to commencing this action." SPA 17 (Order of Dec. 18, 2008).

We have considered plaintiff's other arguments and find them to be without merit.

CONCLUSION

In sum, we hold that demand was not excused for plaintiff's suit under section 14 of the 1934 Act, and because plaintiff failed to make a demand prior to commencing this action, his claim must be dismissed.

Accordingly, we AFFIRM the judgment of the District Court.

APPENDIX B — MEMORANDUM AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF NEW YORK DATED DECEMBER 19, 2008

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

No. 07-CV-1130 (SLT)(JMA)

JEFFREY W. BADER,

Plaintiff,

v.

LLOYD C. BLANKFEIN, *et al.*,

Defendants.

Dec. 19, 2008

MEMORANDUM and ORDER

TOWNES, District Judge.

Plaintiff Jeffrey W. Bader, brings this derivative action on behalf of Goldman Sachs Group, Inc. ("Goldman" or the "Corporation"), a Delaware corporation traded on the New York Stock Exchange ("NYSE"), alleging that defendants violated Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C.

§ 78n(a), and Delaware state law by filing a proxy statement on February 21, 2007 (the "2007 Proxy Statement") that contained false and misleading information. Plaintiff's complaint alleges that the 2007 Proxy Statement, which asked the shareholders to vote on the Corporation's Board of Directors, misstated the "grant date present values" of stock options which had been granted to three directors and two other highly compensated employees in Fiscal Year 2006, thus misleading the stockholders as to the enormity of the compensation packages bestowed upon these individuals.

Defendants now move to dismiss this action, arguing, *inter alia*, that plaintiff failed to make a demand on Goldman's Board of Directors prior to commencing this action. Plaintiff concedes that he did not make such a demand, but argues (1) that no such demand is necessary in § 14(a) actions and (2) that such a demand would have been futile because of a majority of the Corporation's directors were not disinterested and independent. For the reasons set forth below, this Court concludes that a demand was necessary and was not futile, and that this action must, therefore, be dismissed due to plaintiff's failure to satisfy the "demand requirement," a precondition for bringing this action.

Appendix B

BACKGROUND

Goldman, a Delaware corporation, is a global investment banking and securities firm, headquartered in New York City. *See* http:// www2.goldmansachs.com/ s/prospectus/Prospectus Summary.html. At all times relevant to this action, its Board of Directors consisted of thirteen members, each elected annually for a one-year term. Three of these directors-defendants Lloyd C. Blankfein, Gary D. Cohn, and Jon Winkelried (collectively, the "Employee Directors")—are officers of Goldman; Mr. Blankfein is Chairman of the Board and Chief Executive Officer, while Messrs. Cohn and Winkelried are both presidents of the Corporation and co-Chief Operating Officers (Complaint at ¶¶ 19-21). The other ten directors are "independent," insofar as they have been determined by Goldman's Board of Directors not to have any direct or indirect material relationship with Goldman. *See* http:// www2.goldmansachs.com /our-firm/corporate-governance/corporate-governanc e-documents/policy-regarding-director-independence-determ.pdf. At the time this action was commenced in March 2007, the independent directors were defendants John Browne (also known as Lord Browne of Madingley), John H. Bryan, Claes Dahlbäck, Stephen Friedman, William W. George, Rajat K. Gupta, James A. Johnson, Lois D. Juliber, Edward M. Liddy and Ruth J. Simmons. *See* Complaint at ¶¶ 8-17.

On February 21, 2007—approximately one month prior to the 2007 Annual Meeting of its shareholders—Goldman filed the 2007 Proxy Statement, which asked

the shareholders to vote, *inter alia*, to re-elect all thirteen directors for year-long terms expiring at the 2008 shareholders' meeting. The 2007 Proxy Statement was prepared in accordance with Schedule 14-A, 17 C.F.R. § 240.14a-101, which prescribes the information that must be included in a proxy statement. Item 8 of Schedule 14-A provides that, if a proxy statement solicits action with regard to the election of directors, the proxy statement must include "the information required by Item 402 of Regulation S-K." Item 402, which is set forth at 17 C.F.R. § 229.402, mandates the disclosure of specific information relating to executive compensation.

Among the disclosures mandated by Item 402 is information concerning stock options which have been granted by the corporation to the chief executive officer of the corporation and the other four most highly compensated executive officers during the preceding fiscal year. At the time the 2007 Proxy Statement was issued, Item 402(c)(2) dictated that this stock option information be presented in a table, listing, *inter alia*, the number of securities underlying the options granted, the percentage that each grant represents of all options granted to employees during that fiscal year, the per-share exercise or base price of the options and the expiration dates of the options. 17 C.F.R. § 229.402(c)(2)(ii)-(v). Item 402(c)(2)(vi) further required that the table include information concerning the value of the options, but provided two alternatives for supplying this information. Under the first alternative, the table had to include at least two additional columns stating

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"[t]he potential realizable value of each grant of options . . . , assuming that the market price of the underlying security appreciates in value from the date of grant to the end of the option . . . at the . . . annualized rates [of] 5% . . . [and] 10% . . . ." 17 C.F.R. § 229.402(c)(2)(vi)(A).[1] Under the second alternative, the table had to include the "grant date present value" of the options—that is, "[t]he present value of the grant at the date of grant." 17 C.F.R. § 229.402(c)(2)(vi) (B).

There are several option pricing models that can be used to calculate "grant date present value," including the Black-Scholes model and the binomial option pricing model.[2] Item 402(c)(2) (vi)(B) expressly provided that any option pricing model could be utilized. However, the Instructions to Item 402(c)(2) required that the table providing the stock option information include a footnote "describ[ing] the valuation method used" to derive the "grant date present value." Instructions to Item 402(c)(2) at ¶ 9. In addition, the Instructions to Item 402(c)(2) provided:

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1. If the exercise or base price was below the market price of the underlying security at the date the option was granted, the table had to include a third "column labeled 0%, to show the value at grant-date market price." 17 C.F.R. § 229.402(c)(2)(vi)(A)(3).

2. The Black-Scholes model-the only model relevant to this case-calculates "a theoretical call price (ignoring dividends paid during the life of the option) using the five key determinants of an option's price: stock price, strike price, volatility, time to expiration, and short-term (risk free) interest rate." *See* http://www.hoadley.net/options/bs.htm.

Appendix B

> Where the registrant has used a variation of the Black-Scholes or binomial option pricing model, the description shall identify the use of such pricing model and describe the assumptions used relating to the expected volatility, risk-free rate of return, dividend yield and time of exercise. Any adjustments for non-transferability or risk of forfeiture also shall be disclosed.

In preparing the 2007 Proxy Statement, Goldman elected to provide the "grant date present value" of stock options granted to CEO Blankfein and its four other most highly compensated executive officers: Presidents Cohn and Winkelried, Vice Chairman John S. Weinberg and Executive Vice President David A. Viniar. As required by the instructions to Item 402(c)(2), the 2007 Proxy Statement included a footnote which stated that the "grant date present value" was "based on *a* Black-Scholes option pricing model." 2007 Proxy Statement (attached as Ex. 1 to Declaration of David M.J. Rein, Esq., dated July 20, 2007) at 17, fn. (b)) (emphasis added). The footnote then described the assumptions used as follows:

> The exercise price of each Option ($199.84) is equal to the closing price-per-share of Common Stock on the NYSE on December 15, 2006, the date the Options were granted. The *primary* inputs to the Option valuation model were: 27.5% volatility; 4.6% risk-free rate of return; 0.7% dividend yield; and 7.5

> year expected life, which reflects the sales restrictions on the underlying shares that apply until January 2011. The values of Options described above are hypothetical and have been provided solely to comply with the rules of the SEC. The actual value, if any, that will be realized upon the exercise of an Option will depend upon the difference between the exercise price of the Option and the market price of the Common Stock on the date that the Option is exercised.

Id. (emphasis added). Although the terms in the footnote which this Court has italicized at least suggested that Goldman was using a variant of the original Black-Scholes model, the footnote did not describe the variation and made no mention of any adjustments to the model for non-transferability or risk of forfeiture.

On March 16, 2007, a Goldman stockholder, plaintiff Jeffrey W. Bader, commenced this derivative action pursuant to section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), and Delaware state law, principally alleging that the "grant date present values" set forth in the 2007 Proxy Statement were "materially false." Complaint at ¶ 39.[3] Using the assumptions set

3. Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), makes it unlawful to solicit a proxy "in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe . . . . ." One such rule-Rule 14a-9, 17 C.F.R. § 240.14a-9-prohibits solicitation of a

(Cont'd)

forth in the 2007 Proxy Statement at page 17, footnote (b), plaintiff calculates the "correct Black-Scholes Value[s]" of the options as being approximately 50% greater than the values reported in the proxy statement. *Id.* For example, plaintiff calculates that the correct grant date present value of stock options granted to CEO Blankfein in the 2006 fiscal year was $15,915,974, not $10,453,031 as stated in the 2007 Proxy Statement. *Id.* Similarly, the 2007 Proxy Statement lists the grant date present value of options granted to Presidents Cohn and Winkelried in fiscal year 2006 as $10,253,191, while plaintiff calculates that the correct value is $15,611,694. *Id.* Plaintiff alleges that "[t]hese differences are material because of the sizes of the amounts and because these values are expressly and affirmatively required by statute and regulation." *Id.*

Plaintiff's complaint further alleges that these miscalculations—which plaintiff attributes to "negligence" on the part of the directors and defendants Viniar and Weinberg (Complaint at ¶ 51)—caused other information in the 2007 Proxy Statement and Goldman's other SEC filings to be materially false. Plaintiff claims that, because Goldman underestimated the grant date present value of CEO Blankfein's stock options by $5,462,943, page 26 of the 2007 Proxy Statement falsely reports Mr. Blankfein's total compensation for Fiscal

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(Cont'd)

proxy by means of a proxy statement that is "false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading. . . ."

Year 2006 as a mere $54,723.364—not $60,186,307. Complaint at ¶ 40. Plaintiff claims that this same error caused Goldman to misreport Mr. Blankfein's compensation in another SEC filing: Form 10-K.

Plaintiff also finds fault with that portion of the 2007 Proxy Statement in which Goldman's Compensation Committee reports that it "engaged outside consultants to assist it with benchmarking and analyses with respect to executive compensation and benefit practices and design," 2007 Proxy Statement at 21, and that the Committee "relied on a survey prepared by consultants regarding compensation levels in 2005 for certain of the most highly compensated employees" at similar institutions, such as Lehman Brothers Holdings, Inc., Morgan Stanley, Merrill Lynch & Co., Inc., Citigroup Inc., and J.P. Morgan Chase & Co. *Id.* at 23. Plaintiff claims that these statements "represent[ ] that [Goldman's] executive pay is within the range of the executive pay at the comparable companies" when, in reality, it is so much higher "as to shock the conscience." Complaint at ¶ 46.

Defendants now move to dismiss the complaint on various grounds, including the ground that plaintiff failed to make a pre-suit demand that the Goldman Board of Directors themselves bring this suit on behalf of the Corporation. In his complaint, plaintiff concedes that he never "made any demand on . . . [Goldman's] board of directors to institute this action against the individual defendants." *Id.* at ¶ 26. However, plaintiff's complaint alleges that no such demand was necessary

because acts in violation of § 14(a) are "not the product of a valid exercise of business judgment," which the demand requirement was created to protect. *Id.* at ¶ 30. In addition, the complaint alleges that plaintiff's failure to make such a demand should be excused because a majority of the Goldman directors were not "disinterested and independent," for reasons discussed below.

DISCUSSION

The Demand Requirement

As plaintiff's complaint expressly states, this is a derivative action, brought by a shareholder "in the right of and for the benefit of" a corporation. Complaint at ¶ 3. Derivative actions have their origins in equity. They were devised in the early 19th century to address the "possibilities for abuse" arising from the fact that stockholders could not "call corporate managers to account in actions at law." *Ross v. Bernhard*, 396 U.S. 531, 534, 90 S.Ct. 733, 24 L.Ed.2d 729 (1970). The derivative action, which "permits an individual shareholder to bring suit to enforce a corporate cause of action against officers, directors, and third parties," curbed these abuses by giving shareholders a mechanism to "protect the interests of the corporation from the misfeasance and malfeasance of faithless directors and managers." *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95, 111 S.Ct. 1711, 114 L.Ed.2d 152 (1991) (internal quotations and emphasis omitted).

The remedy itself, however, provided opportunities for abuse by enabling private shareholders to bring so-called "strike suits"—actions "brought not to redress real wrongs, but to realize upon their nuisance value." *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548, 69 S.Ct. 1221, 93 L.Ed. 1528 (1949). "Concerned about the potential for abuse of the remedy . . . , equity courts established as a precondition for . . . [a derivative action] that the shareholder demonstrate that the corporation itself had refused to proceed after suitable demand, unless excused by extraordinary conditions." *Scalisi v. Fund Asset Mgmt. L.P.*, 380 F.3d 133, 138 (2d Cir.2004) (internal quotations omitted); *see Hawes v. City of Oakland*, 104 U.S. 450, 460, 26 L.Ed. 827 (1882). These preconditions were subsequently incorporated into various Equity Rules, then into Rule 23(b) of the Federal Rules of Civil Procedure, and are now included in Fed.R.Civ.P. 23. 1.[4] *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530, n. 5, 104 S.Ct. 831, 78 L.Ed.2d 645 (1984); *Ross*, 396 U.S. at 534, n. 4.

Notwithstanding its incorporation into the Federal Rules of Civil Procedure, "the function of the demand doctrine in delimiting the respective powers of the individual shareholder and of the directors to control

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4. Rule 23.1 provides, in pertinent part, that a derivative complaint must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort."

corporate litigation clearly is a matter of 'substance,' not 'procedure.' " *Kamen*, 500 U.S. at 96-97. The "demand requirement" upholds the fundamental precept that directors manage the business and affairs of the corporation by "afford[ing] the directors an opportunity to exercise their reasonable business judgment" in determining whether and how to pursue the proposed litigation. *Daily Income Fund*, 464 U.S. at 533. In addition, the "demand requirement" promotes alternative dispute resolution by permitting the directors to fashion a solution that avoids litigation altogether. As the Second Circuit has noted:

> Permitting corporations to assume control over shareholder derivative suits ... has numerous practical advantages. Corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation. Deference to directors' judgments may also result in the termination of meritless actions brought solely for their settlement or harassment value. Moreover, where litigation is appropriate, the derivative corporation will often be in a better position to bring or assume the suit because of superior financial resources and knowledge of the challenged transactions.

Lewis v. Graves, 701 F.2d 245, 247-48 (2d Cir.1983) (internal citations omitted).

Appendix B

In light of the history and purpose of the demand requirement, the basis for the derivative action brought by the shareholder is irrelevant. After all, a "strike suit" can be based on technical violations of any of a number of statutes. Regardless of the statutory basis, the corporate directors must be given the opportunity to exercise their "reasonable business judgment" and to determine not only whether a potential derivative plaintiff's demand has merit, but also whether an action or omission giving rise to a meritorious claim is best remedied through litigation or some alternative means.

Plaintiff's Claim That the Demand Requirement Does Not Apply in this Case

The plaintiff in this case, however, urges this Court to rule that the "demand requirement" is inapplicable if the shareholder derivative action alleges only a violation of section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a). Plaintiff's argument is principally based on *Vides v. Amelio*, 265 F.Supp.2d 273 (S.D.N.Y.2003), in which Judge Stanton held that, "under Delaware law and federal policy, there is no need for prior demand upon the board of directors with respect to the claim of misstatements and omissions in . . . [a] proxy statement." *Id.* at 276. However, for the reasons explained below, this Court declines to follow *Vides*.

In *Vides*, the plaintiffs—like plaintiff herein—brought a derivative action pursuant to section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9, alleging that information contained in a corporation's

proxy statement was false and misleading. Defendants moved to dismiss the complaint, arguing, *inter alia*, that the plaintiffs had failed to make a pre-suit demand upon the corporation's board of directors. Judge Stanton declined to dismiss the derivative action on this basis. He reasoned that while the "demand requirement" might ordinarily be necessary to afford corporate directors the opportunity to exercise their reasonable business judgment, demand was unnecessary in § 14(a) cases because no "business judgment" was involved in deciding whether to include certain information in a proxy statement. Rather, the decision concerning whether to include information in a proxy statement was entirely a legal one—*i.e.*, whether that information was material.

Although Judge Stanton may have been correct in observing that the decision of whether to include information in a proxy statement does not require an exercise of business judgment, he ignored the fact that directors must still use their business judgment in deciding what course of action to take when alerted to a materially false statement in a corporate proxy statement. Under such circumstances, the directors must do more than simply engage in a legalistic determination of whether the defects are material; they must also decide whether litigation is the best avenue to rectify the problem. If shareholders could elect to sue on behalf of a corporation without consulting the board of directors whenever they deemed a proxy statement to contain materially false information, shareholders could effectively usurp the board's decision

as to whether litigation was merited. The "demand requirement" permits the board, in the exercise of its business judgment, to choose forms of "alternate dispute resolution," and thereby upholds "the fundamental precept that directors manage the business and affairs of corporations." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del.1984), *overruled on other grounds, Brehm v. Eisner*, 746 A.2d 244 (Del.2000).

The opinions on which *Vides* principally relied—*Galef v. J.A. Alexander*, 615 F.2d 51 (2d Cir.1980), *In re Anderson, Clayton Shareholders' Litig.*, 519 A.2d 669 (Del.Ch.1986), and the unpublished *In re Tri-Star Pictures, Inc. Litig.*, Civ. A. No. 9477, 1990 WL 82734 (Del.Ch. June 14, 1990)—do not support the conclusion that the demand requirement does not apply to § 14(a) cases. These three cases relate to the "business judgment rule"—a doctrine that "bars judicial inquiry into actions of directors taken in good faith and in honest pursuit of the legitimate purposes of the corporation." *Galef*, 615 F.2d at 57. Those portions of the cases quoted by Judge Stanton support the proposition that the business judgment rule cannot be interposed as a bar to actions alleging misrepresentations or omissions in proxy statements. However, none of those cases can be read as excusing a shareholder from making a demand upon the corporate board before commencing a derivative action alleging a violation of section 14(a).

This Court is not alone in rejecting Judge Stanton's reasoning with respect to this issue. In the five and one-half years since *Vides* was decided, no fewer than five

other district courts have expressly refused to follow it. *See Risberg ex rel. Aspen Tech., Inc. v. McArdle*, 529 F.Supp.2d 213, 225-26 (D.Mass.2008); *In re CNET Networks, Inc. Shareholder Derivative Litig.*, 483 F.Supp.2d 947, 966 (N.D.Cal.2007); *In re F5 Networks, Inc. Derivative Litig.*, Master File No. C06-794RSL, 2007 WL 2476278, at * 14 (W.D.Wash. Aug.6, 2007); *In re Computer Sciences Corp. Derivative Litig.*, Lead No. CV 06-05288 MRP (Ex), 2007 WL 1321715, at * 4, n. 4 (C.D.Cal. Mar. 26, 2007); *St. Clair Shores Gen. Employees Ret. Sys. v. Eibeler*, No. 06 Civ. 688(SWK), 2006 WL 2849783, at *4-*5 (S.D.N.Y. Oct.4, 2006). While *Vides* has been cited by two other courts—*Benzon v. Morgan Stanley Distributors, Inc.*, No. 3:03-0159, 2004 WL 62747, at *4 (M.D.Tenn. Jan.8, 2004), and *In re Elan Corp. Sec. Litig.*, No. 02 Civ. 865(RMB)(FM), 2004 WL 1305845, at *16 (S.D.N.Y. May 18, 2004) (Report and Recommendation of Maas, M.J.)—neither of these courts has followed *Vides* for the proposition that demand is not required in § 14(a) actions. In addition, other courts (including the Second Circuit) which have not specifically considered *Vides* or this particular issue, have dismissed § 14(a) claims for failure to make a demand on the board. *See, e.g., Lewis*, 701 F.2d at 247-50; *In re IAC/InterActiveCorp Sec. Litig.*, 478 F.Supp.2d 574, 606, n. 17 (S.D.N.Y.2007).

Plaintiff's Claim That Demand Would Have Been Futile

Although this Court concludes that the "demand requirement" applies to this case, this Court also recognizes that "demand may be excused where a

shareholder is able to show that demand would be futile." *Scalisi*, 380 F.3d at 138. "The specifics of what constitutes futility vary from state to state." *Id.* (citing 13 William Meade Fletcher *et al.*, *Fletcher Cyclopedia of the Law of Private Corporations* § 5965 (perm. ed. rev.vol.2004)). Accordingly, "[t]he substantive law which determines whether demand is, in fact, futile is provided by the state of incorporation of the entity on whose behalf the plaintiff is seeking relief." *Id.* (citing *Kamen*, 500 U.S. at 108-09).

Since Goldman is incorporated in the State of Delaware, this Court must apply Delaware law to determine whether demand was futile in this case. In Delaware, the test for determining whether the "demand requirement" should be excused as futile is "whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Rales v. Blasband*, 634 A.2d 927, 933 (Del.1993) (quoting *Aronson*, 437 A.2d at 814). The second method of establishing futility is unavailable, however, in cases "where the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit." *Id.* at 933-34.

In order to allege facts creating reasonable doubt as to whether "the directors are disinterested and independent," a plaintiff need not allege facts showing that each director is neither interested nor independent.

Rather, a plaintiff must show that a *majority* of the directors is either interested or not independent. *See, e.g., In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 363 (Del.Ch.2008) (quoting *Orman v. Cullman*, 794 A.2d 5, 22 (Del.Ch.2002)). Under Delaware law, "[a] director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders." *Rales*, 634 A.2d at 936 (Del.1993) (citing *Aronson*, 437 A.2d at 814). A director may also be "interested" if "a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders." *Id.* A director is "independent" if his or her decision "is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Aronson*, 437 A.2d at 816.

In this case, plaintiff does not allege that Goldman's Board of Directors was involved in preparing or reviewing the 2007 Proxy Statement, or that the Board made any business decision regarding the calculation or reporting of the "grant date present value" of the executives' stock options. Rather, plaintiff alleges that the directors could not have impartially considered plaintiff's demand for various reasons. First, plaintiff's complaint alleges that the Employee Directors "are interested in the material understatement of their option grants and total compensation because it creates the illusion that they are more compliant with their statutory and fiduciary duties of disclosure and their fiduciary duties not to accept excessive compensation" and are "financially interested in receiving more

compensation." Complaint at ¶ 27. Second, the complaint states that two "independent" directors, Messrs. Dahlbäck and Friedman, are both interested and lack independence because Goldman has invested $600 million in entities to which Mr. Dahlbäck serves as a adviser, and has invested $670 million in Funds managed by Mr. Friedman. *Id.* at ¶¶ 10-11, 28. Third, the complaint alleges that Mr. Friedman and five other "independent" directors—Ms. Simmons, Lord Browne, and Messrs. Gupta, Liddy, and Bryan—are interested and lack independence because they sit on the boards of directors of various nonprofit organizations and have "been assisted in their fund raising responsibilities by the [Goldman Sachs] Foundation, which is funded by [Goldman]," or (in the case of Mr. Bryan) by Goldman itself. *Id.* at ¶¶ 8-9, 11, 13, 16-17, 28. Finally, the complaint states that all thirteen directors are neither disinterested nor independent "since every member of the board is liable for the material misstatements and omissions in the Proxy Statement," *id.* at ¶ 30(d), and because the directors "sought to entrench themselves." *Id.* at ¶ 30(e).

It is most efficient to analyze plaintiff's allegations of futility in reverse order, beginning with the claim that all thirteen directors are interested or lack independence because they were involved in the wrongdoing which is the subject of this litigation. Although this argument is entirely logical, Delaware and federal courts alike have long held "claims of directorial participation in and liability for the wrongs alleged, coupled with a reluctance by directors to sue

themselves," inadequate to establish futility. *See, e.g., Pogostin v. Rice*, 480 A.2d 619, 625 (Del.1984), *overruled on other grounds, Brehm v. Eisner*, 746 A.2d 244 (Del.2000); *Aronson*, 473 A.2d at 815, 818; *Graves*, 701 F.2d at 248-49. The *Graves* Court succinctly explained the rationale for rejecting this argument as follows:

> To construe [this argument] as sufficient [to establish futility] would mean that plaintiffs could readily circumvent the demand requirement merely by naming as defendants all members of the derivative corporation's board. Permitting plaintiffs to employ this tactic would eviscerate Rule 23. 1, a rule that this Court has vigorously enforced.

701 F.2d at 249.

Similarly, plaintiff's claims of "entrenchment" lack sufficient specificity since they do not allege that "the board members' prospects of remaining in office were ever in serious doubt" or would have been in doubt had the alleged misstatements in the 2007 Proxy Statement been revealed to shareholders. *See In re Morgan Stanley Derivative Litig.*, 542 F.Supp.2d 317, 323 (S.D.N.Y.2008), *see also Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 175 (Del.Ch.2005) (a plaintiff asserting entrenchment as a basis for demand futility "must prove that the directors believed they were vulnerable to being removed from office, and that they took entrenchment action."). In fact, the 2007 Proxy Statement indicates that all thirteen directors were

running for re-election unopposed. 2007 Proxy Statement at 12, 60 (stating that "shareholders will be asked to elect the thirteen nominees set forth below" and that "[a]ll of the nominees currently are members of the Board of Directors . . . ."). Since every member of the board was unopposed in his or her bid for re-election and the complaint contains no other allegations regarding the directors' entrenchment, there is no basis for excusing demand on this basis. *See In re Morgan Stanley Derivative Litig.*, 542 F.Supp.2d at 323 (citing *Graves*, 701 F.2d at 250).

his Court turns next to plaintiff's argument that some of the supposedly "independent" directors were not actually independent because a Goldman-funded non-profit organization—The Goldman Sachs Foundation, Inc. (the "Foundation")—has made charitable contributions to organizations with which these directors were affiliated.[5] For these allegations to

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5. For example, plaintiff's complaint alleges:

1. The Foundation "pledged funding in an undisclosed amount to share in the support of a position of Program Director at The Swearer Center for Public Service at Brown University," where Ms. Simmons serves as president (Complaint at ¶ 17);

2. The Foundation has, since 2002, donated $380,000 to the London School of Economics and Political Science and $3.5 million to the Tsinghua University School of Economics and Management in Beijing, China-two institutions where Lord Browne sits on

(Cont'd)

be relevant to the issue of director independence, plaintiffs must allege that Goldman had "he unilateral power . . . to decide whether the challenged director continues to receive a benefit. . . ." *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust ex rel. Fed. Nat'l Mortgage Ass'n v. Raines*, 534 F.3d 779, 794 (D.C.Cir.2008) (quoting *Orman*, 794 A.2d at 25, n. 50). Absent such allegations, "contributions to non-profit charities and organizations provide no basis . . . to question the independence of the directors for purposes of Delaware law." *See id.*

(Cont'd)

> an "advisory board." In addition, the Foundation donated $500,000 to the Stanford Educational Leadership Institute in 2005, when Lord Browne was "chairman emeritus of the advisory board of the Stanford University Graduate School of Business" (Complaint at ¶ 8);
>
> 3. The Foundation has, since 2002, donated $1.6 million to the Indian School of Business in Hyderabad, India, where Mr. Gupta is chairman of the board, and $3.5 million to the Tsinghua University School of Economics and Management in Beijing, China, where Mr. Gupta-like Lord Browne-sits on the dean's advisory board. In addition, the Foundation has donated $1,665,000 to the Model UN program, and Mr. Gupta is a member of the United Nations Commission on the Private Sector and Development (Complaint at ¶ 13);
>
> 4. The Foundation has, since 2003, donated $190,000 to clubs and programs supported by the Boys and Girls Clubs of America, an organization of which Mr. Liddy serves as chairman (Complaint at ¶ 16).

Appendix B

Plaintiff's complaint does not allege that Goldman's executives have the power to decide whether the Foundation will continue to fund the charities and non-profit organizations with which the Goldman directors are affiliated. Indeed, it seems doubtful that plaintiff could make such an allegation, since the Foundation has its own independent board of directors. *See* http://www2.goldmansachs.com /citizenship/philanthropy/publications-andresources/gsf-annual-reports/2006-annual-report.pdf.

Plaintiff's complaint also questions the independence of another "independent" director—John H. Bryan—alleging that Goldman itself made "substantial contributions" to a campaign chaired by Mr. Bryan, which sought to raise $100 million to renovate the Chicago Lyric Opera House and Orchestra Hall. Complaint at ¶ 9. While Goldman may have, at some point, been able to withdraw its support for this campaign, it seems highly unlikely that Goldman still could have done so in 2006. The $100 million renovation to the Opera House was completed in 1996. *See* http://www.lyricopera.org/about/house.asp.

Plaintiff's remaining arguments relate to only five of the thirteen directors. Since plaintiff must show that a *majority* of the directors—*i.e.*, at least seven of the thirteen—are either interested or not independent, *see, e.g., In re Transkaryotic Therapies, Inc.*, 954 A.2d at 363;*Orman*, 794 A.2d at 22, there is no reason for this Court to consider plaintiff's remaining arguments. Plaintiff's complaint does not create a reasonable doubt

that the majority of the directors are disinterested and independent, and therefore fails to establish that it would have been futile to make a demand upon Goldman's Board of Directors prior to commencing this action.

CONCLUSION

For the reasons stated above, the instant derivative action is dismissed due to plaintiff's failure to make a demand upon the Board of Directors of Goldman Sachs Group Inc. prior to commencing this action. The Clerk of Court is directed to enter judgment in favor of defendants and to close this case.

SO ORDERED.

APPENDIX C — REGULATIONS AND RULE INVOLVED

SCHEDULE 14A, 17 C.F.R. § 240.14a-9

Item 8. Compensation of directors and executive officers.

Furnish the information required by Item 402 of Regulation S-K (§ 229.402 of this chapter) and paragraphs (e)(4) and (e)(5) of Item 407 of Regulation S-K (§ 229.407(e)(4) and (e)(5) of this chapter) if action is to be taken with regard to:

(a) The election of directors;

* * * *

Appendix C

Regulation S-K, 17 C.F.R. § 229.402, Item 402(c)
(Apr. 1, 2006 Edition)

(c) Option/SAR Grants Table.

(1) The information specified in paragraph (c)(2) of this Item, concerning individual grants of stock options (whether or not in tandem with SARs) and freestanding SARs (including options and SARs that subsequently have been transferred) made during the last completed fiscal year to each of the named executive officers shall be provided in the tabular format specified as follows:

(2) The Table shall include, with respect to each grant:

(i) The name of the executive officer (column (a));

(ii) Number of securities underlying option/SARs granted (column (b));

(iii) The percent the grant represents of total options and SARs granted to employees during the fiscal year(column (c));

(iv) The per-share exercise or base price of the options or SARs granted (column (d)). If such exercise or base price is less than the market price of the underlying security on the date of grant, a separate, adjoining column shall be added showing market price on the date of grant;

Appendix C

(v) The expiration date of the options or SARs (column (e)); and

(vi) Either (A) the potential realizable value of each grant of options or freestanding SARs or (B) the present value of each grant, as follows:

(A) The potential realizable value of each grant of options or freestanding SARs, assuming that the market price of the underlying security appreciates in value form the date of grant to the end of the option or SAR term, at the following annualized rates:

(*1*) 5% (column (f));

(*2*) 10% (column (g)); and

(*3*) If the exercise or base price was below the market price of the underlying security at the date of grant, provide an additional column labeled 0%, to show the value at grant-date market price; or

(B) The present value of the grant at the date of grant, under any option pricing model (alternative column (f)).

Appendix C

Instructions to Item 402(c):

9. Where the registrant chooses to use the grant-date valuation alternative specified in paragraph (c)(2)(vi)(B) of this item, the valuation shall be footnoted to describe the valuation method used. Where the registrant has used a variation of the Black-Scholes or binomial option pricing model, the description shall identify the use of such pricing model and describe the assumptions used relating to the expected volatility, risk-free rate of return, dividend yield and time of exercise. Any adjustments for non-transferability or risk of forfeiture also shall be disclosed. In the event another valuation method is used, the registrant is required to describe the methodology as well as any material assumptions.

Appendix C

Rule 14a-9, § 240.14a-9 False or misleading statements.

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

Appendix C

Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.

(a) Predictions as to specific future market values.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.

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No. 09-1113

Court U.S.
APR 15 2010
CLERK

IN THE

Supreme Court of the United States

JEFFREY W. BADER,

Petitioner,

—v.—

LLOYD BLANKFEIN, ET AL.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF *CERTIORARI*

David H. Braff
Counsel of Record
David M.J. Rein
SULLIVAN & CROMWELL LLP
125 Broad Street
New York, New York 10004
(212) 558-4000
braffd@sullcrom.com

Counsel for Respondents

April 15, 2010

QUESTION PRESENTED

Whether this Court should review the Second Circuit's determination that, as a matter of pure Delaware law, pre-suit demand was required in a shareholder derivative action alleging deficiencies in a 2007 proxy statement's disclosures concerning the valuation of employee stock options awards, where (i) the claims are moot because the directors' annual terms expired long ago, the relevant proxy rules have been amended, and shareholders were provided disclosure as to petitioner's valuation theory before voting in the uncontested election, (ii) the Second Circuit properly concluded that pre-suit demand was not excused given the majority of independent, outside directors on the Goldman Sachs board and the latitude provided in the then-applicable proxy-disclosure rules for the board to exercise its business judgment in selecting and applying an option-valuation model, and (iii) there were other grounds not reached by the district court or Second Circuit for dismissal?

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, The Goldman Sachs Group, Inc. states that it is a publicly-held company, which has no parent corporation and that no publicly-held company owns 10% or more of its stock.

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COUNTER-STATEMENT OF THE CASE

Goldman Sachs is a Delaware corporation whose shares are listed on the New York Stock Exchange. This shareholder derivative action challenges the firm's 2007 Proxy Statement filed on Schedule 14A with the U.S. Securities and Exchange Commission ("SEC") on February 21, 2007 in connection with the firm's annual meeting and uncontested election of directors for a one-year term. In particular, the 2007 Proxy Statement disclosed the "Grant Date Present Value" of options granted by Goldman Sachs during its 2006 fiscal year to its Chief Executive Officer and certain other senior executives, and the methodology behind that valuation. Then-applicable SEC regulations required disclosure of certain information regarding executive and director compensation for the previous fiscal year whenever shareholders were asked to vote on the election of board members. (*See* Pet. App. 3a (17 C.F.R. § 240.14a-101, Item 8 (citing Item 402 of Regulation S-K, 17 C.F.R. § 229.402)). The directors were elected by an overwhelming margin, and their one-year term expired in the Spring of 2008.

Petitioner Jeffrey W. Bader filed this shareholder derivative action, alleging (among other things) that the options valuations set forth in the 2007 Proxy Statement were incorrect. At bottom, this action is based on petitioner's counsel's pet theory regarding options-valuation disclosure, variations of which petitioner's counsel has asserted in actions filed in courts across the Nation against well-known corporations for more than a decade. None of these actions, as far as we are aware, have

survived a motion to dismiss.[1] Petitioner's complaint does not seek to recover damages, but seeks injunctive and equitable relief, including an injunction against the 2007 shareholder meeting (held on March 27, 2007), voiding the elections of directors elected at that annual meeting (whose terms expired on April 10, 2008), and an equitable accounting.

Petitioner concededly did not make the demand on Goldman Sachs' Board of Directors that is a prerequisite to maintaining a shareholder derivative action under Delaware law. Rather, petitioner argued that pre-suit demand was excused because, *inter alia*, proxy-disclosure claims are exempt from the pre-suit demand requirement.

Respondents moved to dismiss the complaint based on numerous legal defects, including the failure to make the required demand on Goldman Sachs' Board, mootness and failure to state a claim. The District Court dismissed the complaint in an unpublished decision, holding that petitioner failed

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[1] *See Seinfeld* v *Becherer*, No. 03-5225, slip op. (D.N.J. Jan 27, 2005), *aff'd*, 461 F 3d 365 (3d Cir. 2006) (Honeywell Int'l); *Seinfeld* v. *Bartz*, No. C01-2259 TEH, 2002 WL 243597 (N.D. Cal. Feb. 8, 2002), *aff'd*, 322 F.3d 693 (9th Cir. 2003) (Cisco Systems); *Shaev* v. *Hampel*, No. 99 Civ. 10578 (RMB), 2002 WL 31413805 (S.D.N Y. Oct. 25, 2002), *aff'd*, 74 F. App'x 154 (2d Cir. 2003) (Alcoa); *Resnik* v. *Swartz*, No. 00 Civ. 5355 (LMM), 2001 WL 15671 (S.D.N.Y. Jan. 8, 2001), *aff'd*, 303 F.3d 147 (2d Cir. 2002) (Symbol Technologies); *In re 3COM Corp. S'holders Litig.*, C.A. No. 16721, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999); *Cohen* v. *Calloway*, 667 N.Y.S.2d 249 (N.Y. App. Div. 1998) (General Electric).

adequately to plead that his failure to make pre-suit demand on the Goldman Sachs Board was excused under Delaware law and rejecting petitioner's contention that derivative claims challenging proxy disclosures are exempt from the usual pre-suit demand requirement.

The Second Circuit affirmed the dismissal by summary order, holding that "[t]he particular disclosure at issue . . . was a business judgment," and therefore subject to the demand requirement, because "[t]he information required to be disclosed could not have been done automatically or without thought. Rather, determining which figure to disclose and which pricing model to apply required discretion and an exercise of business judgment." (Pet. App. 5a.) Accordingly, the Court held that pre-suit demand was required and the complaint was dismissed for petitioner's failure to make such demand.

SUMMARY OF ARGUMENT

The Petition should be summarily denied. As a threshold matter, this case has long been moot. In all events, the Second Circuit's nonprecedential summary order correctly applied the established demand futility standard under Delaware law to a particular proxy disclosure made pursuant to a now-superseded regulation and correctly held that demand was required, a result which in no way nullified Delaware law and does not justify departure from this Court's well-settled practice of not reviewing state-law determinations of the federal courts of appeals.

REASONS FOR DENYING THE WRIT

I. The Petition Should Be Denied Because This Action Is Moot.

As an initial matter, the Petition should be denied because the claims at issue are moot. This action does not seek to recover damages and concerns application of a now-superseded regulation to a three-year-old proxy statement, issued in connection with the uncontested 2007 election of directors for an annual term (among other matters), where voting shareholders were provided disclosure of petitioner's valuation theory. *See Church of Scientology of Cal.* v. *United States*, 506 U.S. 9, 12 (1992) ("It has long been settled that a federal court has no authority to give opinions upon moot questions or abstract propositions, or to declare principles or rules of law which cannot affect the matter in issue in the case before it." (internal quotation marks omitted)).

Subsequent to the filing of this action, several developments have occurred that render it impossible for petitioner to obtain the relief he seeks. Petitioner's complaint requests (i) an injunction against Goldman Sachs' 2007 annual meeting; (ii) equitable relief against defendants from hereafter engaging in the practices as particularized in the complaint; (iii) voiding the elections of directors for 2007; and (iv) an equitable accounting. The 2007 annual meeting occurred on March 27, 2007, and the one-year terms of the directors elected at that annual meeting—the election petitioner seeks to void—expired when new directors were elected on April 10, 2008 (indeed, yet another election of directors

occurred on May 8, 2009). Further, "the particular SEC regulation at issue in [petitioner's] claims is no longer in effect."[2] (Pet. App. 3a.) As a consequence of these developments, the relief sought in this action cannot be granted and the action is accordingly moot.[3] *See City of Erie* v. *Pap's A.M.*, 529 U.S. 277, 287 (2000) (case is moot where it becomes impossible for the court to grant any effectual relief to the prevailing party). The Petition should be denied on this basis alone.[4]

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[2] Relevant excerpts of then-current 17 C.F.R § 229.402 are set forth at Pet. App. 32a-34a. Specifically, as the Second Circuit's decision recognized, 17 C.F.R. § 229.402 permitted disclosure of either "the potential realizable value of stock options granted . . *or* the present value of the stock options granted." (Pet. App 5a; *see also* Pet. App. 33a.) If the present value was disclosed, "it could be calculated under '*any* option pricing model.'" (Pet App. 5a (quoting 17 C.F.R. § 229.402(c)(2)(vi) (emphasis supplied)); *see* Pet. App. 33a.) This regulation has since been amended to require the disclosure of present value. (*See* Pet 3; Pet App. 3a.)

[3] In addition, the existence of this action and a description of petitioner's claims were fully disclosed to Goldman Sachs shareholders in a supplemental proxy statement sent prior to the 2007 annual meeting, thus enabling them to consider petitioner's theory for themselves and further mooting his claims *See Telenor E. Invest AS* v. *Eco Telecom Ltd.*, No. 05 Civ. 7584 (GEL), 2005 WL 2239999, at *3 (S.D.N.Y. Sept 7, 2005) (disclosure to shareholders of the disputed facts is remedy for disagreement regarding valuation); *Avnet, Inc.* v *Scope Indus.*, 499 F Supp. 1121, 1125 (S.D.N.Y. 1980) (same).

[4] The Second Circuit concluded that this action was not moot on the basis that the "underlying alleged wrongful conduct" was capable of repetition, yet would evade review if the action were deemed moot. (Pet. App. 3a.) However, because the governing regulation has been superseded, the alleged

II. The Second Circuit Did Not Err in Holding That Pre-Suit Demand Was Required and in No Way "Nullified" Delaware Law.

A. The Second Circuit Correctly Held That Pre-Suit Demand Was Required in This Case.

The Second Circuit correctly determined that this action was governed by the well-established requirement under Delaware law that pre-suit demand be made as a prerequisite to bringing a derivative action unless the plaintiff can plead with particularity sufficient grounds to excuse demand under Delaware law. (*See* Pet. App. 4a (citing *Aronson* v. *Lewis*, 473 A.2d 805 (Del. 1984), *overruled on other grounds by Brehm* v. *Eisner*, 746 A.2d 244 (Del. 2000)).) The Second Circuit then properly analyzed whether pre-suit demand was required under the *Aronson* test. (*See* Pet. App. 5a.) The Petition does not argue that the court below erred in apprehending that Delaware's pre-suit demand

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violation of that regulation is not "capable of repetition." Moreover, even reading the complaint more broadly as alleging "misleading calculations in proxy statements under section 14" (Pet. App 3a), petitioner's claims are not "evading review," as he has filed two subsequent lawsuits based on the same theory and challenging options-valuation disclosures in Goldman Sachs proxy statements under the now-current regulation. Both actions are currently pending before the District Court. *See Bader* v. *The Goldman Sachs Group, Inc.*, No. 08 Civ. 255 (SLT) (E.D.N Y.) (2d Am. Compl. filed March 24, 2010); *Bader* v. *Winkelried*, No. 09 Civ. 2607 (SLT) (E.D.N.Y.) (filed Mar. 24, 2009).

requirement governs this action, or in setting forth the substantive elements of the *Aronson* analysis. The Petition, accordingly, at most challenges the Second Circuit's application of those standards, which alone counsels denial of the writ. *See* Sup. Ct. R. 10 (writ of *certiorari* "rarely granted when the asserted error consists of . . . misapplication of a properly stated rule of law").

Petitioner contends that the demand requirement does not apply here because the challenged stock option valuations should have been mechanical and entailed no exercise of business judgment. The Second Circuit, however, recognized that the proxy regulation permitted disclosure of "*either* the potential realizable value of stock options granted to officers *or* the present value of the stock options granted," and that, if the latter course were chosen, the present value could be calculated under "*any* option pricing model." As a result, the Court properly concluded that "discretion and an exercise of business judgment" were required in making the requisite disclosure. (Pet. App. 5a (internal quotation marks omitted).) This reasoning accords with Delaware law.

The Petition does not explain why a bare allegation of a disclosure violation sets forth facts "so egregious on [their] face that board approval [could not] meet the test of business judgment." *Aronson*, 473 A.2d at 815. At its core, petitioner's argument would automatically excuse demand in every case concerning alleged proxy misstatements. Such a result would, as *Aronson* reasoned in an analogous context, render the demand requirement

"meaningless" and "leav[e] the clear mandate of [Delaware] Chancery Rule 23.1 devoid of its purpose and substance." *Id.* at 814. To the contrary, as the Second Circuit recognized, under *Aronson*, the demand inquiry is necessarily fact specific. (*See* Pet. App. 4a.) *See also Aronson*, 473 A.2d at 814-15 ("entire [demand] review" is "factual in nature," whereby "the alleged wrong is substantively reviewed against the factual background alleged in the complaint"). Thus, the Second Circuit concluded that "[t]he particular disclosure at issue on this appeal was a business judgment," but that the Court could "anticipate a situation in which demand would be futile, and thus excused under the second prong of *Aronson*, in a section 14 derivative suit." (Pet. App. 5a.)

The cases discussed in the Petition do not support the argument that pre-suit demand is always excused in disclosure cases. Petitioner describes *In re Anderson, Clayton Shareholders' Litigation*, 519 A.2d 669 (Del. Ch. 1986), as the "leading case" addressing whether the business judgment rule applies to proxy-disclosure claims. (Pet. 5.) *Anderson* did not, however, address the derivative pre-suit demand requirement at issue here at all. *Anderson* was not a derivative suit but, rather, involved shareholders' direct claims. *Id.* at 671. Accordingly, *Anderson* did not discuss or decide the issue addressed by the Second Circuit: whether pre-suit demand is required when a derivative plaintiff challenges proxy disclosures.

Similarly, none of the other Delaware Chancery Court cases cited by petitioner addressed

the pre-suit demand requirement with regard to proxy-disclosure claims. *Lewis* v. *Leaseway Transportation Corp.*, C.A. No. 8720, 1990 WL 67383, at *1 (Del. Ch. May 16, 1990), was a direct shareholder class action. *In re Mobile Communications Corp. Consolidated Litigation*, C.A. No. 10627, 1989 WL 997182, at *1 (Del. Ch. Apr. 3, 1989), was a shareholder suit seeking to enjoin a corporate reorganization plan. Neither case addressed the issue of pre-suit demand.

In re Tri-Star Pictures, Inc., Litigation, C.A. No. 9477, 1990 WL 82734, at *2, *8-9 (Del. Ch. June 14, 1990), dismissed all the derivative claims for lack of standing and allowed only a direct claim to proceed. Indeed, *Tri-Star* explicitly recognized that "if the disclosure claims were derivative, they would be subject to the demand requirement," *id.* at *8, and an earlier decision in the same litigation contains a detailed analysis of whether director interest would have rendered pre-suit demand futile, *see Siegman* v. *Tri-Star Pictures, Inc.*, C.A. No. 9477, 1989 WL 48746, at *9-12 (Del. Ch. May 5, 1989).

Finally, the Second Circuit's summary order is in accordance with the overwhelming majority of other federal courts that have addressed Delaware's pre-suit demand requirement in the proxy-disclosure context.[5]

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[5] *Compare Risberg ex rel. Aspen Tech., Inc.* v. *McArdle*, 529 F. Supp. 2d 213, 225-26 (D. Mass. 2008); *In re CNET Networks, Inc.*, 483 F Supp. 2d 947, 966 (N.D. Cal. 2007); *In re Computer Scis. Corp. Deriv. Litig.*, No CV 06-05288 MRP, 2007 WL 1321715, at *4 n.4 (C.D. Cal. Mar. 26, 2007); *St. Clair*

B. The Second Circuit Did Not "Nullify" Delaware Law.

This Court does not generally review the lower federal courts' decisions on pure issues of state law, and will not grant *certiorari* to do so except in the most "extraordinary" circumstances. *Leavitt* v. *Jane L.*, 518 U.S. 137, 144-45 (1996) (per curiam); *see also Haring* v. *Prosise*, 462 U.S. 306, 314 n.8 (1983) ("[S]tanding alone, a challenge to state-law determinations by the Court of Appeals will rarely constitute an appropriate subject of this Court's review."); *Pierson* v. *Ray*, 386 U.S. 547, 558 n.12 (1967) ("We do not ordinarily review the holding of a court of appeals on a matter of state law . . . .").

Straining to bring his Petition within the rubric of this Court's decision in *Leavitt*, petitioner describes the Second Circuit's ruling that pre-suit demand was required in this case as a "blatant federal-court nullification of state law." (Pet. 5.) This assertion is absurd. As an initial matter, the Second Circuit was not asked to, and did not, strike down a challenged state law and thereby bar the state from enforcing it, as did the lower court in *Leavitt*.

Moreover, far from having "nullified" Delaware law, as discussed above, the Second Circuit applied and enforced a well-established requirement of Delaware law. *See Aronson*, 473 A.2d at 812.

Shores Gen. Employees Ret. Sys. v. *Eibeler*, No. 06 Civ. 688 (SWK), 2006 WL 2849783, at *4-7 (S.D.N.Y. Oct. 4, 2006), *with Vides* v. *Amelio*, 265 F. Supp. 2d 273 (S.D.N.Y. 2003).

Unlike the extraordinary circumstances presented in *Leavitt*—in which the Tenth Circuit ignored an express severability provision when striking down a Utah abortion statute as unconstitutional—petitioner cannot point to any binding Delaware authority that the Second Circuit "nullified." In fact, far from having any kind of "nullifying" effect, the summary order here is not even precedential authority within the Second Circuit. *See* 2d Cir. L.R. 32.1.1(a) ("Rulings by summary order do not have precedential effect.").

Petitioner does not assert that the Second Circuit failed to apply a controlling statute or ruling of the Delaware Supreme Court. Rather, the Petition alleges only that the Second Circuit's decision was "unsupported by any Delaware case" and supposedly is in conflict with a handful of Delaware lower court decisions. (Pet. 6-7.) This is far from rising to the level of the "extraordinary" circumstances that could implicate this Court's *certiorari* jurisdiction. And, as discussed above, it is also wrong: the Delaware cases petitioner cites did not discuss pre-suit demand in the context of a shareholder derivative suit.

Given that the Second Circuit's nonprecedential decision did not "nullify" Delaware law so as to justify *certiorari* under *Leavitt*, 518 U.S. at 144, this Court should follow its well-settled practice and deny the Petition. *See Haring*, 462 U.S. at 314 n.8.

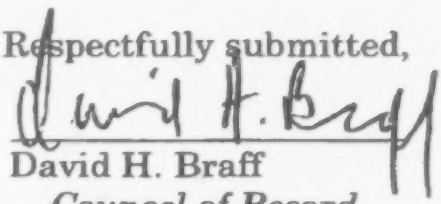
III. Dismissal of This Action Is Warranted on Numerous Other Independent Grounds Not Reached By the Courts Below.

Although not reached by the Second Circuit, the District Court's dismissal of this action may be affirmed on numerous alternate grounds, as argued by Respondents below. Specifically, the complaint failed adequately to plead any viable claim, because the allegedly false and misleading disclosures were stock option valuations, which numerous courts have held are "soft information" that is inherently immaterial as a matter of law. In addition, the complaint fails to satisfy the particularized pleading requirements of Rule 9(b) and the Private Securities Litigation Reform Act of 1995. Each of these grounds, standing alone, would independently support dismissal of this action, underscoring why review would be inappropriate by this Court.

CONCLUSION

For the reasons discussed above, this Court should deny the Petition.

Respectfully submitted,



David H. Braff
Counsel of Record
David M.J. Rein
SULLIVAN & CROMWELL LLP
125 Broad Street
New York, New York 10004
(212) 558-4000
braffd@sullcrom.com

Counsel for Respondents

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No. 09-1113

IN THE

Supreme Court of the United States

JEFFREY W. BADER,

Petitioner,

v.

LLOYD BLANKFEIN, ET AL.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF

ALEXANDER ARNOLD GERSHON
Counsel of Record
GLORIA KUI MELWANI
BARRACK, RODOS & BACINE
1350 Broadway, Suite 1001
New York, New York 10018
(212) 688-0782
agershon@barrack.com

Counsel for Petitioner

229504

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

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Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands – Reprise*, 28 CARDOZO L. REV. 1287 (2006) ... 2

I. The Second Circuit Stood Delaware Law On Its Head

The respondents argue that the Second Circuit did not blatantly nullify Delaware law. They contend that the Second Circuit did not strike down Delaware law and did nothing egregious.[1] Instead, the respondents argue, the Second Circuit applied and enforced Delaware law. The respondents are wrong.

Delaware is where most of the U.S. publicly held corporations are incorporated. Unsurprisingly, Delaware takes a great interest in matters of corporate law and governance. The Delaware Supreme Court holds that stockholders' derivative actions are an important part of corporate life and that such actions are one of the "potent tools to redress the conduct of a torpid and unfaithful management." *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

The Delaware pre-suit demand rule and its exceptions are indispensible to the Delaware way of corporate life, and to the way of corporate life for the many states that have a futility exception to the demand

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[1] The respondents cite *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984), to say that, under the *second* prong of *Aronson*, conduct must be egregious on its face to be unprotected by the business judgment rule and that there is nothing egregious about a disclosure violation. The respondents misread *Aronson*, which was addressing the *first* prong of *Aronson*, and the question of whether a board's conduct was so wrongheaded as to create a substantial risk of liability and to make them interested under the first prong.

rule. *In re PSE&G Shareholder Litigation*, 173 N.J. 258, 278-79, 801 A.2d 295, 307-08 (2002) (most jurisdictions will excuse demand if making it would be futile). The issue at bar is one of broad application, not only to the many Delaware corporations, but also to the many states that follow or accept guidance from Delaware corporation law. Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands – Reprise*, 28 CARDOZO L. REV. 1287, 1287-88 (2006) (American courts look to Delaware's "rich abundance of corporate law." Delaware court system is the "Mother Court of corporate law.")

The Second Circuit's decision was not just a "state-law [mis]determination by the Court of Appeals." *Haring v. Prosise*, 462 U.S. 306, 314 n.8 (1983). Nor was it a "reasonable construction of state law." *Id.* Nor was it a mere "misapplication of a properly stated rule of law," as contemplated in Rule 10 of the Supreme Court Rules. Rather, the Second Circuit's decision stood Delaware law on its head and subverted a long-standing rule, carefully worked-out by the Delaware courts.

At bar, the excusal of demand may be expressed as a major premise, a minor premise, and a conclusion. The major premise is that Delaware law excuses pre-suit demand in a stockholder's derivative suit where the complaint alleges a reasonable doubt that the challenged transaction is the product of a valid exercise of business judgment. *Aronson v. Lewis*, 473 A.2d at 814.

The minor premise is that disclosure of false information cannot be the product of the valid exercise

of business judgment, particularly where the disclosure affects such a fundamental matter as stockholder voting for directors. This is not just a Delaware rule expressed in *In re Anderson, Clayton Shareholders' Litigation*, 519 A.2d 669, 675 (Del. Ch. 1986). It is universally accepted. 3 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1040 n.15, 16, 17 (2009); 1 DENNIS J. BLOCK, NANCY E. BARTON, STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE : FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS, 41, 508-10 (5th ed. 1998).

The conclusion is that pre-suit demand is excused under Delaware law where the challenged transaction is the distribution of a false proxy statement that solicits stockholder votes.

The respondents argue that authorities such as *Anderson, Clayton* do not apply at bar because they do not hold, *in haec verba*, that pre-suit demand is excused, only that, in other contexts, false proxy statements are not protected by the business judgment rule. In this connection they cite *In re Tri-Star Pictures, Inc., Litigation*, 1990 WL 82734 at *8 (Del. Ch. June 14, 1990), from which they quote, "if the disclosure claims were derivative, they would be subject to the demand requirement." (Opp. at 9.) That quote elides the language that makes the respondents' argument false. That quote, in context, is:

> [I]f the disclosure claims were derivative, they would be subject to the demand requirement of Rule 23.1, which is rooted in business judgment rule considerations. *Aronson v.*

> *Lewis*, 473 A.2d 805, 812 (Del. Supr. 1984). Yet, that result would be inconsistent with Delaware case law holding that the business judgment rule does not apply to "... the question whether shareholders have, under the circumstances, been provided with appropriate information upon which an informed choice on a matter of fundamental corporate importance may be made. . . ." *In re Anderson, Clayton Shareholders' Litigation*, 519 A.2d 669, 675 (Del. Ch. 1986).

What the *Tri-Star* court was saying was that under *Anderson, Clayton* pre-suit demand is excused in a stockholder's derivative suit where the challenged transaction is a false proxy statement, which is not protected by the business judgment rule.

A recent Delaware Chancery Court case illustrates the point. In *Weiss v. Swanson*, 948 A.2d 433, 441-48 (Del. Ch. 2008), the court excused demand, holding that the board's timing of stock option grants to precede good corporate news and to follow bad corporate news and its failure to disclose that conduct were not protected by the business judgment rule. The court held that failure to report those practices were material omissions in a proxy statement for stockholders "in deciding whether to . . . re-elect board members." *Id.* at 433 (footnote omitted). The *Weiss* opinion is replete with references to inadequacies in the proxy statements as grounds to excuse demand. The court addressed the second prong of *Aronson* and held that there was a reasonable doubt that these option grants and the omitted disclosures concerning their timing were the result of a valid exercise of business judgment.

The respondents argue that the Second Circuit came to the correct decision on pre-suit demand in that it was in accordance with the overwhelming majority of federal district courts, four in number, cited in footnote 5 of their brief, compared to one case in the petitioner's favor. *Vides v. Amelio*, 265 F. Supp. 2d 273 (S.D.N.Y. 2003). Three of those four cases do not address the second prong of *Aronson*, and the fourth does, but gets it wrong. That fourth case, *St. Clair Shores Gen. Employees' Ret. System v. Eibeler*, 2006 WL 2849783 at *4-7 (S.D.N.Y. Oct. 4, 2006), held that even though the board's conduct was not protected by the business judgment rule, the board had the business judgment to decide to bring or reject the case. That ruling is the opposite of Delaware law.

The correct decision was in *Vides v. Amelio*, which cited *Tri-Star* and *Anderson, Clayton*, and held that since a false proxy statement is not protected by the business judgment rule, pre-suit demand was excused under Delaware law. The *Vides* court cited *Katz v. Pels*, 774 F.Supp. 121, 127, n.5 (S.D.N.Y. 1991), and *Estate of Detwiler v. Offenbecher*, 728 F.Supp. 103, 150, n.18 (S.D.N.Y. 1989), which also held that pre-suit demand was excused under Delaware law where a stockholder's derivative action challenges a false proxy statement. In accord is the decision by Judge Farnan in *Seinfeld v. Barrett*, 2006 WL 890909 at *3 (D. Del. Mar. 31, 2006).[2]

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[2] The Second Circuit did not address federal policy. In *Vides v. Amelio*, 265 F.Supp. 2d at 276, the court held that, in addition to Delaware law, the federal interest in enforcing the federal securities laws was sufficient to excuse demand. In *In re Westinghouse Securities Litigation*, 832 F.Supp. 989, 997-98 (W.D. Pa. 1993), the complaint alleged stockholders' derivative (Cont'd)

II. The Case At Bar Is Not Moot

The respondents contend that the Second Circuit should have dismissed this case as moot, but that it did not do so because it found that the alleged wrong "is capable of repetition, yet evading review." *Bader v. Blankfein*, 2009 WL 4822818 at *1 (2d Cir. Dec. 14, 2009) (Citation omitted) (Pet. App. 3a). The respondents say that the regulation at issue here "has been superseded," so that the wrong is not capable of repetition. (Opp. fn 4.) The respondents omit to say that the Second Circuit addressed the change in the regulation and disagreed, saying:

> While we recognize that the particular SEC regulation at issue in plaintiff's claims is no longer in effect, the underlying alleged wrongful conduct – providing misleading calculations in proxy statements under section 14 – is a wrong that is "capable of repetition, yet evading review." *Heldman*, 962 F.2d at 157 n.9. Plaintiff's appeal is, therefore, not moot.

Bader v. Blankfein, 2009 WL 4822818, at *1 (Pet. App. 3a). The change in the regulation was to restrict the

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(Cont'd)
claims based on breach of fiduciary duty and false proxy statements. The court held that the business judgment rule does not apply to violations of the federal securities laws. It also held that disclosure duties are independent of duties concerning the management of corporate affairs. It further held that, regardless of the directors' independence, demand on the board is excused as a matter of federal policy, where the complaint alleges a violation of § 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a). *Id* , at 997-98.

disclosure to the present value of stock options and to eliminate the choice of disclosing the potential realizable value of stock options. (Pet. App. at 33a.)

The respondents also argue that the issues in this case will not evade review because the petitioner has filed two other cases, in 2008, similar to the instant case. They omit to say that in one of those cases they have moved to dismiss on the grounds that it, too, is moot.[3] As the respondents see it, this issue will always be moot because it is impossible to finish a case before the board's term expires. But, as the court held in *Bader v. Goldman Sachs Group, Inc.*, 311 Fed. Appx. 431 at *1 (2d Cir. Feb. 23, 2009), while some parts of the case are moot, e.g., seeking a preliminary injunction, others are not. The court said "[T]he district court has retained jurisdiction over plaintiff's underlying claim, which it will consider on the merits in due course." *Id.* at *1 (citation omitted).

III. The Petitioner's Counsel Of Record Does Not Have A "Pet Theory" Of Stock Option Valuation

Finally, the respondents say that the petitioner's counsel of record has taken the case at bar as part of his "pet theory regarding options – valuation disclosure." In three years of litigation, the respondents have raised this "pet theory" theory, but they not been able, and are still are unable to articulate what that pet theory is.

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[3] The other case does not seek to excuse demand based on a false proxy statement, so the precise pre-suit demand issue at bar will not arise.

All of those cases cited in footnote 1 are materially different from the case at bar. At bar, the complaint alleges that the proxy statement falsely reported the value of stock options *previously* granted to senior officers in connection with a vote to elect directors, in violation of 17 C.F.R. § 229.402(c)(2)(vi)(B) (Pet. App. at 33a), and 17 C.F.R. § 240.14a-9 (Pet. App. at 35a). In those footnote 1 cases, by contrast, the complaints alleged that where the proxy statements solicited stockholder approval of proposed stock option plans for options to be granted for years *in the future*, the proxy statements should report the Black-Scholes present value of all the options to be granted in the plans. But, the SEC did not and does not specifically require Black-Scholes values, 17 C.F.R. § 240.14a-101 (Item 10), which is why the footnote 1 cases were dismissed. Other SEC regulations, however, provided for reporting Black-Scholes values for stock options that *had been granted*, 17 C.F.R. § 229.402(c)(2)(vi)(B) (2006) (Pet. App. at 33a), relevant at bar, but not for stock options that *might be granted in the future*, not relevant at bar. The courts held that in the absence of a specific SEC requirement to report Black-Scholes values, such disclosure was not required.

CONCLUSION

Nearly all stockholders' derivative actions challenging proxy statements are brought in federal court because the applicable statute, § 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa, provides for exclusive federal jurisdiction. Such actions, if brought in state courts, must proceed without the protection of § 14(a) of the Exchange Act, 15 U.S.C. § 78n(a), and the rules and regulations of the United States Securities and Exchange Commission. Because issues of state corporation law inevitably arise, the federal courts must accept state law as it actually is and reject their own ideas of what that state law should be. At bar, the Second Circuit got Delaware law so wrong that it blatantly nullified it. The Supreme Court should grant the petition for writ of certiorari.

Respectfully submitted,

ALEXANDER ARNOLD GERSHON
Counsel of Record
GLORIA KUI MELWANI
BARRACK, RODOS & BACINE
1350 Broadway, Suite 1001
New York, New York 10018
(212) 688-0782
agershon@barrack.com

Counsel for Petitioner